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Treacherous Currents

"Recovery, given the present structure of the economy, will eventually produce new inflation. So in recent times we have been on a dismal roller coaster: resorting to recession to combat inflation, and then resorting to inflation to combat recession. This is a hell of a way to run a railroad."

The Cycles of American History
Arthur M. Schlesinger, Jr., 1986

Earlier this year, we made two specific and quite alarming predictions for the course of events in 1995. In February, we warned of a looming dollar crisis, driven by a flight of short-term "hot money" speculators away from the falling greenback. In March, we forecast an imminent hard landing for the U.S. economy, triggered by the collapse of unsustainable booms in business inventories and consumer borrowing.

Perhaps we can be forgiven for feeling a certain sense of vindication for our bearish views. Wall Street and the world financial community, which bet so heavily on a rising dollar and vigorous economic growth, again have been caught badly wrong-footed. Signs of recession are multiplying, and the dollar has resumed it sickening plunge.

In this issue, we assess the implications of a U.S. recession for global bond and stock markets. Our conclusion: A severe bear market appears unavoidable. As always, Wall Street sets the agenda for the rest of the world. Once the flight to cash begins in earnest in America, the effects will be transmitted quickly to foreign markets. The global liquidity squeeze, which hammered markets last year, is entering a new, even more dangerous stage.

Ordinarily, a declining U.S. economy would be expected to boost bond markets, sending yields sharply lower. But this is no ordinary downturn. The United States now is caught in a classic debt crisis, in which a collapsing currency forces long-term interest rates higher, even in the face of economic stagnation. That this scenario has not unfolded already is entirely due to foreign central banks, who have propped up both the dollar and the U.S. bond market with their massive interventions.

This rescue campaign will become increasingly more difficult as the U.S. economy weakens. As we explain, the United States is dependent as never before on short-term capital flows to sustain its external deficit. Recession is sure to trigger a further flight of such hot money away from the dollar. We seriously doubt both the ability and the willingness of foreign central banks to stave off disaster indefinitely.

For the Federal Reserve, there simply are no good options. Raising rates to defend the dollar would whipsaw the hordes of leveraged speculators who have jumped back into the U.S. bond market this year, chasing the rally created by the central banks. Lowering rates to prevent a downward economic spiral could easily trigger a dollar crash. Leaving rates unchanged will please no one, and create the impression the Fed is paralyzed. This could breed panic.

In the end, we suspect the Fed will bow to its political masters and lower rates. Such a move almost certainly would come too late to head off recession, but by putting further downward pressure on the dollar, it could ensure that any U.S. slump spreads quickly to America's trading partners. This would be especially bad news for Japan, already teetering on the brink of a deflationary meltdown. It seems the age of beggar-thy-neighbor has returned.

WALL STREET LEADS THE WAY

Once again, Wall Street is playing a pivotal role in setting the trend for global financial markets. Markets outside the United States don't have strong minds of their own. They just follow New York's lead. While this year's surge in bond and stock prices was worldwide, Wall Street obviously led the way. Conspicuously, U.S. bonds and stocks scored the biggest gains among the major countries. To understand global trends, it is necessary to understand Wall Street trends.

Since November, U.S. bonds and stocks have staged a rampant rally. For bonds, it has been the biggest rise in prices since late 1987, in the wake of the stock market crash. What was the dramatic event that triggered this rally?

Conveniently, Wall Street likes to attribute the bull run to the sweeping victory of the Republicans in the U.S. congressional elections. According to many commentators, American investors suddenly were taken in by unbridled faith in the determination and ability of the Republicans to put the U.S. economy right again.

It's a neat *ex post* bull story. Only, as is easily checkable, it bears no resemblance to the facts. Let's put them straight. As 1994 drew to an end, U.S. private households were slashing their bond purchases after prior heavy buying. What's more, U.S. financial institutions were either selling bonds or busily building up short positions in Treasuries and Eurodollar futures. Wall Street was outright bearish on bonds.

What, then, launched the bond rally? Heavy buying of U.S. bonds in the fourth quarter came from one source only: private foreign investors. They bought at an annual rate of $133 billion. We guess they were primarily betting on a rising dollar, which virtually everybody expected to follow from rising U.S. interest rates.

This general bearishness towards bonds had its counterpart in overwhelming bullishness towards stocks and the dollar, which, indeed, did rally for two or three months. The stock rally was supposed to be driven by soaring corporate earnings, while the dollar's was linked to expected rate increases by the Fed.

As it turned out, the Wall Street consensus proved mostly wrong and partly right for the wrong reason. The common, decisive false premise was the consensus view that the U.S. economy, while already hitting capacity limits, would continue to boom and thus compel the Fed to make additional tightening moves. At the beginning of January, futures markets expected three-month U.S. interest rates to rise to 8.36% by September, as against the present 6%.

But to Wall Street's utter surprise, the economic news suddenly turned much weaker than expected. As the bond rally, in response, gained momentum, a large part of Wall Street found itself outright short. A rush of the bears to cover these positions surely played an important role in keeping the bond rally going.

Soon enough, Wall Street began to intone the gleeful mantra of the economy's impending, picture-perfect soft landing – a painless slowdown of economic growth to an annual rate of 2.5%, ushering in a gold age of sustained, strong growth, low inflation, falling interest rates and a steady rise in profits, assuring booming bond and stock markets forever.

Since then, however, even weaker economic data have sowed growing doubts about the validity of the "soft landing" scenario. In particular, the unexpectedly grim employment report for April, released on May 8, dealt a heavy blow to the still optimistic growth forecasts. As the bond bears capitulated *en masse*, a real buying panic unfolded.

These letters always have warned that the soft-landing forecasts were seriously flawed. We never have accepted the chief argument behind those forecasts: that the prevailing low inflation rate proves the Fed has done a magnificent job in preventing the usual excesses and imbalances that typically signal the end of the business cycle.

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (May 26)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	0.7%	5.8%	-3.5%	-4.6%	11.0%
Canada	3.3%	5.0%	2.2%	-0.5%	11.8%
France	-1.2%	2.0%	-8.3%	-9.4%	11.5%
Germany	2.3%	-1.4%	-2.5%	-6.1%	8.7%
Hong Kong	12.6%	13.9%	-1.6%	-8.2%	33.9%
Japan	-6.7%	-20.4%	-23.4%	-27.2%	2.0%
Mexico	-2.4%	-17.5%	-20.2%	-31.4%	35.4%
Spain	6.7%	4.6%	-9.7%	-9.7%	12.8%
U.K.	2.6%	8.0%	9.7%	-0.5%	15.1%
U.S.	2.1%	14.0%	14.6%	-0.9%	18.3%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (May 26)	Current Rate (%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	8.82	-102	-122	18	-189	26
Canada	8.04	-28	-110	-47	-164	14
France	7.46	-32	-81	36	-97	36
Germany	6.70	-34	-92	-12	-106	0
Japan	3.10	-31	-147	-79	-186	0
Spain	11.35	-77	-49	-173	-121	173
U.K.	7.93	-42	-78	-33	-110	6
U.S.	6.39	-62	-143	-71	-164	1

Exchange Rates

Versus U.S. Dollar, % Change

Country (May 26)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.39	-0.9%	-6.8%	-1.7%	-8.0%	0.6%
Canada ($)	1.37	-0.7%	2.2%	1.2%	-2.2%	3.7%
France (*f*)	4.86	-0.3%	9.0%	13.8%	-1.9%	14.9%
Germany (DM)	1.38	-0.8%	11.0%	16.4%	-1.9%	17.5%
Japan (¥)	82.9	1.1%	16.8%	20.8%	-2.8%	21.4%
Spain (Pt)	119.8	2.4%	8.9%	11.8%	0.0%	13.2%
U.K. (£)	1.60	-0.8%	2.5%	6.2%	-2.2%	6.4%

Our fundamental disagreement with Wall Street's soft-landing complacency concerns this particular point. Does the Fed really have everything under control? In our view, precisely the opposite is true: Credit and money growth both are out of control. Of credit and debt there is far too much, and of money and liquidity far too little. Though price inflation has remained rather low, this recovery nevertheless has been seriously imbalanced in many ways.

LOOSE MONEY

Confronted with the economy's unexpected weakening, Wall Street promptly has changed its mind. It now argues the Fed is too tight, instead of too loose.

We have always shared the view that U.S. monetary policy is excessively lax. But, unlike Wall Street, we still stick to it. The abrupt downturn in the U.S. economy cannot be explained by any credit restraint. In fact, credit conditions remain extremely loose, despite the Fed's rate hikes. Banks and other institutions are competing with unusual aggressiveness to expand lending, while stubbornly low rates on bank deposits reveal that there is little or no competition for deposits.

Yet, we have warned for some time that the U.S. economy would turn much weaker than generally expected. This assessment, however, had nothing to do with the Fed and its policies. In our opinion, this recovery always was much more vulnerable than most people realized, owing to the excesses and imbalances that nobody wanted to see.

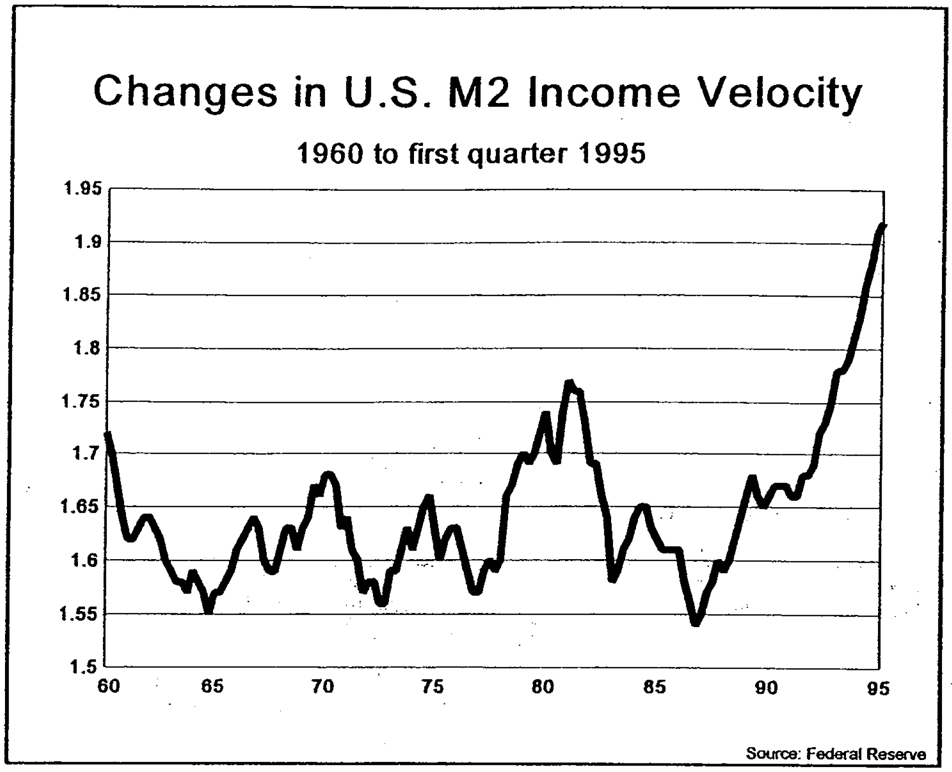
In the first place, far too much of the post-1991 recovery was built on a new consumer borrowing binge, and a surge in business inventories. Both simply were unsustainable. It was continually argued by the bulls that strong consumption demand was assured by strong employment growth. But in reality, the relationship runs the other way around. Employment depends on spending.

In this regard, two facts disturb us. Last year, U.S. personal income rose by $326.6 billion. At the same time, household debts soared by $349 billion. New consumer borrowing has literally doubled since the start of the current recovery in 1991.

Together, consumer income and debt growth in 1994 added up to $675 billion. Yet the simultaneous rise in spending on consumption ($250 billion) and residential building ($32 billion) totalled just $282 billion. Looking

at these figures, we keep wondering where all the earned and borrowed money really went. The three possible explanations: debt service, financial speculation, and higher savings. Whatever the answer, who could seriously assume that such a borrowing and spending binge was sustainable?

The second, most obvious inflationary excess associated with the current U.S. economy recovery has been the frenzied craze for financial speculation, fueled by heavy debt-leveraging and an unprecedented flight from cash. In this case, the dangerous imbalances lie in the financial system and in the balance sheets of investors and speculators who have boosted their debts and depleted their liquidity.



Last, but not least, we always have warned that the virtual stagnation of the broad money stock – *ex* the soaring growth in currency in circulation – is a serious long-run negative both for the U.S. economy and the financial markets. Yet thanks to a collapsing demand for money, and to rampant borrowing outside the banks and heavy financial leveraging, both the economy and the markets have boomed. This has resulted in an unprecedented surge in money velocity.

STORM WARNINGS

To be sure, the most important question at present for investors and business executives worldwide is the U.S. economy's impending slump. This is particularly true in light of our initial comment – that the world's bourses dance to the tune of Wall Street. Unexpected U.S. economic weakness undoubtedly will hit global stock markets and the dollar. Already, the release of just a few weak economic numbers has been sufficient to wreck the May dollar rally, which was so widely heralded by the dollar bulls.

Still, most of those who now speak of a hard landing for the U.S. economy actually have a different scenario in mind. They regard the current slowdown as a temporary pause, to be followed later in 1995 by a strong rebound in growth, accompanied by rising inflation and interest rates. This would then set the stage for a truly significant Fed tightening, resulting in the inevitable recession. Until very recently, few have been willing to consider the possibility of a hard landing in the sense of an imminent recession.

Our own argument – that the U.S. economy will prove even weaker than expected – rests mainly on the assumption that consumption, residential building and inventory investment, which together accounted for some 86% of 1994 U.S. GDP growth, definitely have peaked.

Assuming little or no push from government spending, any rebound of the economy would depend on a tremendous acceleration in exports and business investment. But given the relatively small size of both demand components in

U.S. GDP, we have difficulty in seeing this. If consumer spending fails to rebound in the near future, a U.S. recession will become highly probable.

For good reasons, the prevailing optimistic economic forecasts count heavily on roaring export growth, stimulated by heavy dollar depreciation and expanding global markets. Some analysts happily conjure up visions of a repeat of the export-led U.S. boom of 1987-89.

We see two problems with this idea of a new, export-led phase to the current recovery. The first is capacity utilization. In 1986-87, the American export boom started at a time when the average manufacturing utilization rate was in the 80-81% range. This time, it's 84-85%, meaning that the U.S. economy is near its existing capacity limits.

The second problem is the sluggishness of domestic demand growth outside of the United States. In 1987-88, domestic demand in the OECD countries – not including the United States – was growing at a 4-5% annual rate. Now, it's barely 3%. And the OECD recently has trimmed its forecasts for growth outside the United States.

A big specific negative for U.S. exports is the sharp economic downturn not only in Mexico but in most of Latin America as well. These countries account for nearly 20% of U.S. merchandise exports. Japan, accounting for another 10% of U.S. exports, is back on the brink of recession. In short, we don't see a U.S. trade miracle.

Admittedly, currency devaluations have had sweeping effects on the trade balances of Britain, Italy and Spain. But prior to their devaluations, these countries had just been though deep recessions in 1992. As a result, there was plenty of spare capacity for a massive shift of available resources into exports and import-substitution production. In other words, their devaluations took place in the best of all possible economic environments.

In the U.S. case, however, this crucial condition for a successful currency depreciation – namely, plenty of spare capacity – is grossly missing, unless we assume an immediate and outright collapse in domestic demand. Generally speaking, when an economy is fully employed, currency depreciations are unable to turn the trade balance.

Just as an aside, we find it quite amusing that in all the recent discussions of U.S. economic growth, the dollar's drastic depreciation generally has been hailed by the bulls as an important stimulant. Yet when talk turns to currency matters, the bulls tend to minimize the extent of any dollar depreciation, when measured on a trade-weighted basis. The two arguments are by definition contradictory, yet that fact has not prevented the bulls from resorting to first one and then the other in their efforts to justify the speculative frenzy in the U.S. financial markets.

SPECULATION OR FUNDAMENTALS?

Concerning those markets – that is, the recent euphoria about bonds, stocks and the dollar – what was behind their abrupt rise? Was it merely speculation, or did it reflect an actual or prospective change in the fundamentals? As always, there have been plenty of after-the-fact explanations offered for the three bull runs. We regard it as our task to analyze and debunk these rationalizations.

Regarding the dollar, we noted without any great surprise how quickly – and incorrectly – many banks and other market players hailed last month's rally as marking the end of the U.S. currency's 14-month decline. Forecasts of a rise towards DM 1.65 and ¥110 abounded virtually overnight. As we have occasionally noted, the apparent, endemic dollar bearishness of the past few months actually was not that deep.

Altogether, we counted three favored explanations for the dollar's brief bull run. First, it was argued that the sharp rally in the U.S. bond market since last November finally was attracting foreign capital. Second, the radical balanced-budget proposals put forward by the Republicans were hailed as signs that the United States at last was

coming to grips with its structural problems. Third, the Clinton administration's move to impose trade sanctions on Japanese luxury auto exports was said to offer hope of curbing the enormous U.S. external deficit.

In a perverse bit of logic, the trade battle was eulogized by the dollar bulls, both as positive evidence the administration cares about the trade deficit, and a sign the White House was abandoning its reliance on an ever-weakening dollar to pry open Japanese markets. What do we think of these bull arguments? They're all drivel:

- From a perspective of current yields, the U.S. bond market really is quite unattractive for foreign investors, in particular after its recent surge. A bond rally, of course, tends to attract foreign seekers of capital gains. But by their nature, such rallies, and the capital gains associated with them, cannot last.

- Looking at the Republican budget proposals, we must say that our American friends who are more familiar with the intricacies of Washington politics than we are tell us the U.S. politicians simply are up to their old tricks again. The GOP budget proposals are filled with the usual gimmicks and evasions. The House budget plan, in particular, is a fraud: It pushes the big spending cuts into the next century, while providing for an immediate, $350 billion tax cut. That Wall Street is making much of these budget plans actually is easy to understand. We, on the other hand, will simply note the headline over a recent article on the budget debate in a Conference Board publication: "Deja Voodoo."

- If the dollar bulls are betting on a significant improvement in the U.S. trade balance in the near future, they have no support from the experts. The OECD, for example, projects further deterioration in both the U.S. trade and current accounts. In any case, we doubt the Clinton administration's willingness to push Japan to the wall on the trade issue. It is in nobody's best interests (not even those of the United States) to have an economic and financial crisis in Japan that spins out of control, eventually dragging down the entire world financial system. It must not be forgotten that Japan, despite its financial troubles, still is the world's largest creditor.

For us, the recent big moves in the markets – bonds, stocks and the dollar – were overwhelmingly speculative forays. In particular, we would say last month's dollar rally was driven by the usual herd of short-term players, hedge funds, etc. This could be seen in the chartist technical patterns traced by the dollar during its upward move. At each perceived barrier, such as DM 1.42, or 85 yen, the rally paused, as players waited to see whether or not the upthrust was running out of steam. Major bull markets rarely begin with such an intense lack of conviction.

CAPITAL ACCOUNT – THE TAIL THAT WAGS THE DOG

But the issue would appear to be academic now. The dollar rally collapsed the very minute the U.S. economic fundamentals worsened, as the hot-money operators bailed out of their speculative positions. The important thing to see now is that the dollar's economic and monetary fundamentals continue to worsen. No genuine recovery is in sight. What makes us so sure? We rely on traditional theory and historical experience.

The obvious big, long-run negative for the dollar is of course the chronic, yawning U.S. trade gap, which is flooding the rest of the world incessantly with dollars. Yet there is no reliable relationship between a country's current account and the exchange rate of its currency. In the last analysis, everything depends on what happens to the country's capital account. Capital flows are what tip the scales between currency weakness and currency strength. "The tail wags the dog," as the late Henry Wallich, a former Fed governor, once said.

While the dollar's movements sometimes appear quite erratic, its major movements nevertheless have shown an empirical regularity. The lesson of historical evidence over the decades is that a cyclical expansion in the United States, relative to the rest of the world, tends to strengthen the dollar by pulling in foreign capital. Though the U.S. current account tends to worsen in this phase of the business cycle, this is more than offset by higher capital

Changing Composition of Net Capital Flows into the United States

	Net Short-Term Flows				Total Short-Term		Net Long-Term	
	Private		Official		Private and Official			
Year	Annual	Cumulative	Annual	Cumulative	Annual	Cumulative	Annual	Cumulative
1981	-44.00	-130.52	-5.31	63.89	-49.31	-66.63	18.19	-40.49
1982	-34.95	-165.47	-7.5	56.39	-42.45	-109.8	12.54	-27.95
1983	14.70	-150.77	-0.36	56.03	14.34	-94.74	10.3	-17.65
1984	41.95	-108.82	-5.48	50.55	36.47	-58.27	42.55	24.9
1985	38.72	-70.10	-7.8	42.75	30.92	-27.35	71.03	95.93
1986	-2.82	-72.92	33.94	76.69	31.12	3.77	90.17	186.10
1987	53.90	-19.02	55.54	132.23	109.44	113.21	62.10	246.2
1988	19.94	0.92	38.81	171.04	58.75	171.96	82.15	330.35
1989	-9.16	-8.24	-15.63	155.51	-24.69	147.27	74.44	404.79
1990	32.77	24.53	34.06	189.57	66.83	214.10	-15	389.79
1991	17.41	41.94	25.86	215.43	49.27	257.37	3.34	393.13
1992	56.40	98.34	43.11	258.54	99.51	356.88	-14.51	376.62
1993	66.85	165.19	70.0	328.54	136.85	493.73	-54.04	324.58
1994	119.21	284.4	60.07	388.61	179.28	873.01	8.9	333.48

Source: Federal Reserve, Merrill Lynch

inflows. Conversely, the dollar usually declines when the U.S. business cycle turns down, as money and capital outflows more than offset the typical improvement in the current account.

Last year brought the first great exception from this historical cyclical rule. Even though the U.S. economy turned sharply upward, associated with a reversal of the DM-dollar short-term interest rate differential of more than 600 basis points, the dollar slumped. This should have warned and alarmed the dollar bulls.

We think this surprising development came about for two main reasons. First, U.S. monetary policy remained far too loose last year. Second, the cumulative oversupply of dollars from the endless, huge U.S. external deficits has begun to weigh on the markets.

The table above illustrates the recent, rapid deterioration of the U.S. balance of payments in the capital account, reflecting two dismal trends. One is the sharp rise in U.S. capital outflows on top of the current-account deficit. The other is the drastic shift in U.S. capital inflows from long-term investment to short-term bank instruments and dollar purchases by foreign central banks.

It should be obvious to all now that the dollar's May rebound was a temporary fluke. If there is one thing that could in theory stabilize the U.S. currency, it is a drastic monetary tightening. But in practice, even this might fail, because the highly vulnerable U.S. financial markets likely would crash, triggering massive capital flight.

In reality, the Fed never will tighten, partly out of fear of pricking the financial bubble, which has been left even more wildly overextended as a result of this year's bull runs in bonds and stocks. A tightening move also would grossly conflict with the Fed's top priority: preventing a U.S. recession.

To be sure, the Fed does face a frightening policy dilemma. It must choose between two fearful evils. But this, of course, is the typical trap faced by any debtor and deficit country whenever its economy weakens. This is one more

reason why we think the Fed has lost control. If it tightens, it will end up with a deep recession, and crashing bond and stock markets. If it fails to tighten, or much worse eases, it will face a crashing dollar.

No doubt, American policymakers and Wall Street both would prefer loose money and a crashing dollar to tighter money and crashing U.S. markets. But they should consider the question of how a dollar panic over time would affect the U.S. financial markets.

We suspect that American policymakers don't have the faintest idea of the risks they are running with their policy of benign neglect of the dollar. This well may reflect an unwarranted complacency bred by the currency's remarkable long-term resilience up until now.

Just like the millions of international investors now holding dollar assets, U.S. officials simply cannot imagine a Mexican peso-style collapse of the dollar, complete with panic selling. What unites them all is the mystic belief that in terms of domestic purchasing power the dollar is grossly undervalued in relation to the DM and the yen, and that in the long run this must give automatic support to the U.S. currency.

It won't. Once more, we can only warn against this comforting belief. There is no "fair value" for a currency that is determined by purchasing power parity for goods and services. As we said earlier, what tips the scales are capital flows. To have a stable currency, a deficit country needs fully offsetting capital inflows. Those depend on relative monetary and market conditions that have no connection to the relative prices of goods and services.

The root problem facing the dollar is the fact that the huge, chronic U.S. current-account deficit, combined with the recent upswing in U.S. capital outflows, now is dumping dollars on the world markets at annual rate of some $200-300 billion. For the first time ever, both the current and long-term capital accounts are in large deficit. We regard this as definitive evidence of a monetary policy that is much too loose.

BALANCED BUDGET ILLUSIONS

No less flawed is the new-fangled credo in the markets that lower budget deficits will strengthen the dollar. Actually, this postulate is doubly flawed, defying both economic logic and experience. Mexico had a balanced budget when the peso collapsed. Japan has a much bigger budget deficit, relative to GDP, than the United States. Yet the yen has soared. In the 1983-85 period, the dollar rocketed in the face of exploding budget and current-account deficits.

What, then, is the central key to currency strength or weakness? We can only repeat and repeat ourselves: The crucial factor is relative monetary conditions. Mexico had a loose monetary policy that fueled excessive spending by the private sector. Japan is in the grips of a savage monetary squeeze and associated asset deflation, which so far the Bank of Japan has been unable to break.

From the puzzle of the dollar's brief recovery, we turn to the global bond rally. We have asked some active market participants what the prevailing sentiment has been, particularly in the U.S. market, which has led the rally. The surprising answer: Outright euphoria. In the first case, the looming U.S. recession is regarded as the best of all possible worlds for the bond market. Many bond bulls also take perverse comfort in the falling dollar, arguing that a renewed collapse of the greenback will force foreign central banks into new, heavy purchases of U.S. Treasuries.

In this fashion, the falling dollar – the traditional *bête noire* of the U.S. bond market – suddenly has been transformed into a big positive. Listening to this story, we can only wonder: Is this cynicism, or stupidity? Probably it is a mixture of both. These people don't even stop to consider how completely they have misjudged the strength of the U.S. economy. Taken by surprise, they simply cook up another bull story.

In our view, the U.S. bond market rally is near its zenith. As we watched the market soar this spring, we kept asking ourselves: Where has all the money come from to drive this frenzied rally? From soaring U.S. savings? Definitely not. From a rising money supply? Definitely not. From where, then? The short answer: from a new, massive round of debt leveraging. Though we find it difficult to believe, it appears to be 1993 all over again.

Extraordinary as the latest leg of the U.S. bond rally has been, its causes have been even odder. In hindsight, it's easy to identify three big sources of Treasury purchases that had nothing to do with the U.S. market's intrinsic value:

- The biggest buyers have been the central banks, including the Federal Reserve. Central banks' holdings of Treasuries have climbed from $683 billion at the end of 1993 to more than $800 billion now.
- Short covering by institutional investors who had bet on an overheating economy with rising inflation and interest rates.
- Maturity hedging by institutional holders of mortgage-backed securities.

The irony of the U.S. bond rally is that its violence largely arose from the fact that, as noted earlier, it caught such a large part of the Wall Street investment community badly wrong-footed. This impelled many institutions to switch abruptly from short to long. By rushing to cover their short positions, and at the same time adding new long positions in an effort to make good their losses, Wall Street investors added a lot of short-term fuel to this bond rally. In effect, they bought it twice.

MORTGAGE MANIA

This explosion in short covering makes for a fairly simple story. But a more complicated force propelling this year's bond rally originated in the market for mortgage-backed obligations, or MBOs. This enormous industry, which scarcely existed a decade ago, since has grown into a $1.5 trillion market. In the process, it has become a tremendous force for volatility in the U.S. bond market.

This instability has one primary cause: In America, a mortgage borrower generally has the option of prepaying the principle owed on his loan at any time. Indeed, the business of refinancing existing mortgages also has evolved into a major U.S. industry, driving down transaction costs.

As a result, whenever U.S. long-term interest rates decline, holders of mortgage securities are faced with soaring prepayments, robbing them of the capital gains that normally would result from falling yields. To hedge against this risk, dealers and speculators in MBOs typically take large long positions in Treasuries of comparable duration.

Wall Street likes these MBOs because they offer higher yields than Treasuries. but they turn malicious when long-term interest rates rise or fall. In a booming market, profits on the long positions incurred in derivatives are supposed to offset the lack of capital gains on the MBOs. But this massive hedging activity drives bond yields down even further, causing MBO maturities to shorten even more, forcing the MBO holders to buy more Treasury futures.

This market reaction is the exact opposite of what happened during last year's bond slump. This was described in some detail in our December 1994 letter (page 8). As rates rose in 1994, mortgage prepayments dwindled, causing MBO maturities and durations to lengthen dramatically. To hedge against the possibility of such losses, MBO speculators had taken short positions in Treasury futures, hoping the profits on those short sales would offset capital losses on their MBO portfolios. But this wave of short sales only drove bond yields higher, causing MBO maturities to lengthen even more, forcing the speculators into still more short sales.

Changes in Bond Yields, Trough to Peak to Present
10-Year Government Bonds, Change in Basis Points

Country	Low	Date	High	Date	Change	Low	Date	Change	Current Yield	CPI Y-Y
USA	5.17%	10/15/93	8.03%	11/7/94	+286	6.38%	5/25/95	-165	6.39%	3.1%
Germany	5.53%	12/31/93	7.76%	10/5/94	+223	6.70%	5/26/95	-106	6.70%	2.1%
U.K.	6.09%	12/29/93	9.03%	9/20/94	+294	7.86%	5/25/95	-117	7.93%	3.3%
France	5.61%	1/3/94	8.43%	11/2/94	+282	7.40%	5/24/95	-103	7.46%	1.6%
Italy	8.52%	2/1/94	13.72%	3/8/95	+520	11.90%	12/5/94	-182	12.48%	5.2%

All in all, it is hard to imagine a more graphic demonstration of the futility of most hedging strategies when markets turn unexpectedly. As one critical commentator recently quipped to us: "The MBO industry now forces Wall Street to buy bonds at the top and sell them at the bottom." Clearly, things haven't worked out as the financial wizards promised when they invented the collateralized mortgage market in the 1980s.

FUNDAMENTAL PROBLEMS

Much of this appears highly technical, but it is of great importance in understanding the extraordinary volatility of the U.S. bond market in general, and its recent rally in particular. The important thing to see is that the rally that started in November has little to do with normal fundamentals, which inherently implies that it is not sustainable.

Oddly, the United States today has the lowest long-term yields in the world, except for Japan and Switzerland. Can this be explained by better U.S. fundamentals?

Not at all. U.S. inflation rates are substantially higher than in Germany, France and the various other European countries. More recently, U.S. consumer prices have been rising at an annual rate of 4.1%. The recent surge in import prices, generated by the weak dollar, almost guarantees that consumer inflation will go higher still, despite the weakening economy.

What's more, the United States also has the lowest national savings rate (private savings minus budget deficits) of any country in the world. Wall Street always jubilates about the excellent fundamentals underpinning the U.S. bond market. But by international comparison, they are in reality the worst. Judging simply by these two measures – inflation and national savings – U.S. bonds are grossly overvalued. In this light, their yields should be at least 1.5-2% higher.

Another important point, of course, is the interaction of the bond market and the dollar. With these low nominal interest rates, how can anybody seriously expect that the United States, the biggest debtor country in the world, will ever attract sufficient foreign capital to finance its huge current-account deficit? Real rates are even worse. To us, all this is just further proof that the bullishness of the U.S. financial markets has one single source: excessive monetary looseness and frenzied speculation.

The Fed has done everything possible in word and deed to encourage this speculation on falling long-term rates. Further fuel has come from weaker economic data, which have taken Wall Street by surprise. That is normal, yes, but this time nothing is normal. Typically, recessions are preceded by rising long-term rates, in contrast to their recent decline. As a reminder, when the 1990-91 recession started, U.S. 10-year bond yields hovered above 8%.

In our opinion, the U.S. bond rally is near its zenith. The major domestic forces that propelled it – that is, the short covering of the speculators and the hedging strategies of the MBO dealers – largely have spent themselves. The yield curve has flattened to the point where leveraging at the federal-funds rate of 6% either is no longer possible or no longer attractive. At current medium-term yield levels, triggering a new round of massive leveraging would require a lower federal-funds rate.

Apparently, Wall Street already is betting on an imminent Fed easing. This has helped push yields on short-term Treasuries to truly absurd levels. While we are highly critical of Mr. Greenspan and the Fed, in contrast to the positive consensus view, we still find it hard to believe the Fed would be reckless enough to lower the federal-funds rate in the face of a tumbling dollar. But clearly, the political pressures to do so are increasing. In the end, the Fed may not be able to refuse.

A cut in U.S. rates in this precarious situation could provoke an outright dollar collapse, with unforeseeable consequences for the world economy and its financial system. The weaker the economy, the greater this danger. For that reason, we certainly do not see any possibility at all the Fed will defend the dollar by raising interest rates.

AT THE PRECIPICE

The one great unknown, both for the dollar and for the U.S. bond market, is the role of the foreign central banks. What will they do if the dollar resumes its steep decline, as we assume? As we mentioned previously, some speculators on Wall Street seem to regard the weak dollar as a blessing for the bond market because it forces foreign central banks to step up their dollar and bond purchases. Our own assumption – which we admit might be wrong – is that the foreign central banks sooner or later will have second thoughts about the domestic inflationary implications of their persistent, massive dollar-support operations.

Certainly, a continuation of purchases on the recent scale would be completely unprecedented. The seriousness of the present dollar crisis, however, also is entirely without precedent. In that sense, we must acknowledge our own limited ability to predict how long the world's central bankers will continue to prop up the United States.

We see absolutely no room for complacency, however. In hailing the actions of the foreign central banks, Wall Street foolishly overlooks the deadly dangers hanging over its head. If the central banks abandon their defense of the dollar, or if they are forced to do so by the immense selling pressures now building in the currency markets, the traditional consequences of a plummeting currency will return with a vengeance. The U.S. bond market would be crushed. The nightmare scenario that we have warned of in past letters – in which long-term interest rates rise even as the U.S. economy falls into recession – would become a reality.

Our final question about bonds concerns the possible consequences for global markets if the U.S. bond rally falters. Without a doubt, these would be negative in the extreme. Though the fundamentals of supply and demand differ considerably from country to country, as do their respective positions in the business cycle, the lessons of last year should be clear: All markets shadow Wall Street.

What, really, is the bond markets' crystal ball? It has become a truism in the markets that long-term interest rates mainly reflect the prevailing inflation expectations in the country in question, and the credibility of its central bank. In many countries, governments and central banks have thereupon drawn the conclusion that an easy way to lower interest rates is to manipulate these expectations in a desired way just by announcing ambitious long-term programs to fight inflation and budget deficits.

The first eminent economist to proclaim the overwhelming influence of expectations on markets and economies was John Maynard Keynes. It went with his assertion that interest rates had no connection to the level of national

savings. His central contention was that they are determined by nothing else other than the public's liquidity preference regarding the total existing money stock. And it is true, a mass flight out of money and into bonds and stocks, combined with heavy debt-leveraging speculation, is precisely what we see behind the recent sharp decline in U.S. long-term interest rates. Keynes, short-term oriented like Wall Street, would approve.

Orthodox theory, on the other hand, always has held that interest rates have the function of adjusting borrowing to current savings. In the United States, credit is vastly in excess of savings.

An American economist, Irving Fisher, is occasionally quoted as the discoverer of the correlation between inflation and interest rates. But in reality, what he wrote is quite different. We quote from Fisher's The Theory of Interest, page 85-86: "Probably the most powerful cause tending to reduce the rate of interest is the love of one's children and the desire to provide for their good. Wherever these sentiments decay, as they did at the time of the decline and fall of the Roman Empire, and it becomes the fashion to exhaust wealth in self-indulgence and leave little or nothing to offspring, impatience to spend and the rate of interest will be high. At such times, the motto 'After us, the deluge,' indicates the feverish desire to squander at the present, at whatever cost to the future."

CONCLUSIONS

We see no reason for us to change any of our past conclusions and recommendations. We called the dollar's slump, as well as the U.S. economy's hard landing. In our March letter we said: "The overriding question for the dollar is whether the U.S. economy is in for a soft or a hard landing. In the case of a soft landing, the dollar will weaken, but in the case of hard landing, it will plunge."

This remains true even at the dollar's present level. The lightening speed with which the dollar collapsed following its May recovery highlights its inherent vulnerability. At the same time, the U.S. authorities have made it all too clear that they don't understand that a collapsing dollar will backlash badly on the U.S. economy and its financial markets.

No less ominous is the unprecedented volatility in the stock market. The probability that U.S. economic news will grow steadily worse, rather than better, is overwhelming. In the end, fear of the developing recession should provide the final blow that triggers a massive flight to liquidity, precipitating a major bear market.

For these reasons, and more, we repeat our long-standing advice: Avoid the coming debacle in the U.S. markets. Seek safety and liquidity in the cash and short-term bonds of the hard-currency countries, primarily Germany, Switzerland, Austria and the Netherlands.

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